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## Repetition, Ritual, and Reputation: How Do Market Participants Deal with (Some Types of) Incomplete Information?

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# REPETITION, RITUAL, AND REPUTATION: HOW DO MARKET PARTICIPANTS DEAL WITH (SOME TYPES OF) INCOMPLETE INFORMATION?

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## INTRODUCTION

Incomplete information is an obstacle to deal-making. It may prevent the parties from agreeing on valuation,<sup>1</sup> thus potentially preventing value-increasing deals from being made. Or perhaps a deal can be made, but negotiations are costlier than they could be. Information problems also exist as to ongoing matters in the parties' relationship.

That this is so is well known.<sup>2</sup> But attention has focused largely on a subset of information problems where there is agreement on what the information is and who has (or will have, or can reliably get) it. I will call this type of information "harder" information, contrasting it with "softer" information as to which there is far less agreement.<sup>3</sup> Seemingly uncontroversially, the task of information acquisition involves doing so until the additional costs are not warranted by the additional benefits and

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\* Professor and James L. Krusemark Chair in Law, University of Minnesota Law School. I benefitted enormously from comments by participants in the 2019 Canadian Law and Economics Association annual meeting, and at The New Legal Realism conference, as well as from discussions with Brett McDonnell and from research by Scott Dewey.

1. Note that "valuation" is being not being used here as a synonym for price; rather, it is being used to mean "terms of exchange," which includes price.

2. Information problems are not the only problems contracting parties face, of course. But this Article's thesis concerns information costs; furthermore, the ultimate analysis, as to parties' concern that they can justify their decisions, is applicable to contracting problems beyond information problems. Moreover, some costs could be characterized as either information costs, transaction costs, or both.

3. Traditionally, the distinction made is between incomplete information that no one has, and incomplete information that is also asymmetric, with one party having it and the other not. See Claire A. Hill, *Beyond Mistakes: The Next Wave of Behavioural Law and Economics*, 29 QUEENS L.J. 563, 569–70 (2004). In my parlance, asymmetric information is apt to be harder, and incomplete information that is not asymmetric is apt to be softer, but the mapping is not perfect.

relatedly, attempting to economize on those costs.<sup>4</sup> But this characterization yields a far more straightforward way to proceed as to the acquisition of harder information than it does as to softer information. The tools to acquire harder information are the ones in the upper, most accessible part of the toolbox; how those tools work is intuitive and direct. By contrast, the tools available to acquire softer information work through a series of sometimes-circuitous inferences. Compare determining whether a business is being sued to appraising prospective ‘fit’ of two businesses or of a potential new employee.<sup>5</sup>

Unlike transactions involving two differently situated parties, transactions such as mergers and acquisitions and other business combinations are treated in the literature as though the parties had equal bargaining power. The deal-making exercise is thus seen as reducing aggregate costs, notably information and more broadly, transaction, costs the parties face. The parties have a community of interest in proceeding in this manner.<sup>6</sup> For obvious reasons, all else equal, buyers would like to pay less and sellers would like to get more. For equally obvious reasons, buyers are wary that sellers can and might exaggerate the quality of what they are selling to get a higher price. In order for the parties to make a deal, the buyer needs to be convinced to pay a price that is acceptable to the seller; this will only happen if the buyer’s concerns that the seller might be misrepresenting the quality of what it is selling can be sufficiently assuaged. And both parties will want to hone their valuations based on whatever else they can find out that might be relevant to the seller’s present situation and future prospects. It is in both parties’ interests to do this as cheaply as possible.

Consider the information problem that has commanded the most attention, the “lemons problem,” in which a buyer is concerned that she would not know if the seller was selling her a “lemon.” The seller wants a non-lemons price; the buyer will pay the price if she believes she is not buying a lemon.<sup>7</sup> What is needed is to credibly elicit the information as to

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4. See Claire A. Hill, *A Comment on Language and Norms in Complex Business Contracting*, 77 CHI.-KENT L. REV. 29, 35–37 (2001) [hereinafter Hill, *Comment*]; Claire A. Hill, *Bargaining in the Shadow of the Lawsuit: A Social Norms Theory of Incomplete Contracts*, 34 DEL. J. CORP. L. 191, at 213, 215 (2009) [hereinafter Hill, *Bargaining*].

5. See Hill, *Bargaining*, *supra* note 4, at 215.

6. See generally Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239 (1984). This seminal and highly influential paper informs the overall framing of what transactional lawyers are seeking to do: make the assumptions of the capital asset pricing model more nearly true. *Id.* at 255. This frame informs my paper as well, although I incorporate the lawyer’s interests as well as her client’s, and my analysis of “information costs” takes into account some second order effects not present in Gilson’s account or in the traditional literature. See also Hill, *Comment*, *supra* note 4, at 35–42.

7. The seminal paper on the lemons problem is George Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

the quality of what is being sold. For instance, the party knowing it (typically the seller) somehow manages to show he is telling the truth, by, for instance, offering some sort of bond, such as a money-back guarantee. Or someone acknowledged as an expert provides the information, again offering a bond in the form of costs, at least to her reputation, if she is wrong. Thus, for the harder information at issue, the solution is incentive alignment between the party wanting the information and the party providing it.<sup>8</sup>

Attention has also been paid to certain information problems in which the information will reveal itself, but only after nature or a third party acts.<sup>9</sup> The information may involve the occurrence or non-occurrence of some discrete future event (a patent being granted, for instance), or future results which don't follow a sufficiently demonstrable trajectory at the time of contracting. As to these problems, the parties reduce information and transaction costs by agreeing on the terms of an ex-post settling up that reflects how nature or the third party acts.

Broadly speaking, attention has been paid to the craft of obtaining credible information as cheaply and efficiently as possible, assigning duties to the best situated parties and making use of experts as appropriate. Implicit in these formulations is that the truth is recognizable as such—to overstate slightly, that we will know when we have found it. The parties can converge on a valuation that they agree sufficiently well reflects (what they accept as) the truth, using various mechanisms to reduce the costs of doing so.

But parties considering entering into a deal want to know more than just “truths that can be revealed” (and that parties think to ask about). They are assessing fit, culture, vision, and the like. And, particularly where the transaction involves one or more private companies, they are considering what they may not have thought to ask about. I characterize this as “softer information.”

Elsewhere, I criticized standard accounts of contracts and contracting. Contracts do not look like documents meant to make the parties' deal clear to a court, as one might expect given that they are being drafted by lawyers

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Akerlof won the 2001 economics Nobel Prize for this paper. *George A. Akerlof Facts*, THE NOBEL PRIZE, <https://www.nobelprize.org/prizes/economic-sciences/2001/akerlof/facts/> [<https://perma.cc/2Z42-HFHP>]; see also *The Market for Lemons*, WIKIPEDIA, [https://en.wikipedia.org/wiki/The\\_Market\\_for\\_Lemons](https://en.wikipedia.org/wiki/The_Market_for_Lemons) [<https://perma.cc/4SJA-3QVJ>] (discussing how often the paper has been cited).

8. None of this is to suggest that the solutions work perfectly; the problem is not really ‘solved,’ but rather, addressed.

9. See CLAIRE A. HILLET AL., *MERGERS AND ACQUISITIONS: LAW, THEORY, AND PRACTICE* 363 (2d ed. 2019); see also Gilson, *supra* note 6, at 262–69.

whose ostensible purpose is just that.<sup>10</sup> Contracting also does not look like a process designed to reduce transaction and information costs as generally understood.<sup>11</sup> But contracts and contracting can be far better understood as solutions to the problem of acquisition of softer information. Among the most important aspects of contracts and contracting that address the problem are repetition, ritual, and reputation. I explain how these solutions work, arguing that the mechanisms at issue support a significant rethinking of certain facets of economic decision-making. An obvious characterization of information acquisition is: a person wants to know X, and does Y—figures out how to give a person who knows X “truth serum,” or hires an expert—to find out. The costs of the truth serum or expert are well-enough known, as is the benefit of knowing X. But in the important softer information cases, the “X” is not such that it yields a “Y” of this sort. Compare how an expert mechanic can inform a decision to buy a car with how an “expert” investor or political consultant can inform an investment decision or predict an election.<sup>12</sup>

The process by which softer information is sought and acquired thus relies on different mechanisms—mechanisms that are anointed as

10. Hill, *Bargaining*, *supra* note 4, at 192–94; *see also* Claire A. Hill, *Why Contracts are Written in “Legalese,”* 77 CHL.-KENT. L. REV. 59, 70–73 (2001) [hereinafter Hill, *Legalese*].

11. *See generally* Hill, *Bargaining*, *supra* note 4, at 193.

My account argues for a view of contracting in which parties aren’t principally trying to set forth an agreement for a court to enforce. The contracting process, and the contract that results, serves importantly to create the parties’ relationship and to set the stage for dispute-resolution consistent with preserving the relationship, as well as to keep available the backstop of enforcement if needed. Sometimes there are economies of scope in these functions. For instance, creating the relationship involves defining what the relationship is; parties bargain to determine what they want and write it down in a document they can bind themselves to and later bring to court. But there are potential diseconomies as well. If parties seek to capture the last, costliest attempt at precision, they probably won’t commensurately reduce their end-game costs. Indeed, they may increase such costs. Bargaining more than is the community norm may shrink the reputational penumbra otherwise created by the contract, encouraging an ethos in which whatever isn’t prohibited is permitted. Accommodation that might help relationship preservation may thereby be crowded out, replaced by a more literalistic and opportunistic mindset on the part of both parties.

*Id.*

12. The orthodox analyses use a simple and caricatured view of expertise as technical expertise in a field where there is a “fact of the matter” that can be demonstrated in some manner that commands consensus, and, going further, that who counts as an expert also commands consensus. Many sorts of expertise do not have this feature. *See generally* FERNAND GOBET, UNDERSTANDING EXPERTISE: A MULTI-DISCIPLINARY APPROACH 1–6 (2016); Harald A. Mieg & Julia Evetts, *Professionalism, Science, and Expert Roles: A Social Perspective*, in THE CAMBRIDGE HANDBOOK OF EXPERTISE AND EXPERT PERFORMANCE 127, 127–48 (K. Anders Ericsson et al. eds., Cambridge Press 2d ed. 2018).

appropriate by the broader transactional community, and whose purpose, in significant part, is to provide the decision-makers with a justification in case of a bad outcome. This is significant for its own sake, but also provides a more nuanced (and surprisingly underappreciated) way to understand how parties pursue their self-interest.<sup>13</sup> That the “hammer” of incentive alignment is so salient has, in my view, led to information problems too often being regarded as “nails.” A richer view of the problems contracting parties face in converging on a valuation and other deal terms can yield a useful addition to the toolbox, as well as insights into how people arrive at their beliefs about what is credible and what is true.

### I. THE PROBLEM PART ONE

There are different ways to categorize different types of incomplete information. The standard terminology is that asymmetric information is a subset of incomplete information, but that information can be incomplete without being asymmetric. Incomplete information is information nobody knows; asymmetric information is information that one party knows far better than the other.

The distinction I am making here is different. I distinguish between information as to which there is agreement on what it is and who has (or will have, or can reliably get) it (“harder information”), and information as to which that is not the case (“softer information”). What motivates my distinction is a focus on strategies to address information problems: Harder information problems can be addressed with different and more tractable strategies than softer information problems.

Returning to the classic asymmetric information problem, the lemons problem, the information is “harder information”: we know what it is—is the “car” a good one?—and who has it—the “car” seller (probably), and various “mechanics.”<sup>14</sup> “Harder information” is also what is sought where information is not asymmetric but simply incomplete because a third party or nature has yet to act, but we can articulate the third party or nature’s

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13. I explore this mechanism and how, why and when it arises in Claire A. Hill, *Justification Norms under Uncertainty: A Preliminary Inquiry*, 17 CONN. INS. L.J. 27 (2010) and Claire A. Hill & Alessio M. Paccos, *The Neglected Role of Justification under Uncertainty in Corporate Governance and Finance*, 3 ANNALS CORP. GOVERNANCE 1, 1–2 (2018).

14. See Akerlof, *supra* note 2, 480–90. Akerlof was arguably more concerned with the effect of lemons on markets: the bad drive out the good. The concern in transactional literature is more that it is in both parties’ interests to figure out as cheaply as possible how each party can convince the other that it is not a lemon. Where the transaction is an acquisition, the buyer mostly needs to show it can and will seek needed approvals and pay as promised; the seller’s task is far more extensive. Where the transaction is a true merger, both parties have a comparably extensive task. See *supra* note 6 and accompanying text.

possible moves (approval or disapproval of agency Y; profits of some specified amount).<sup>15</sup>

In these types of cases, there are well-known solutions. In the lemons problem, two parties are trying to agree on the terms of a deal. One party (call her the buyer) is wary because, as both parties know, the seller has better information about what she is selling, and self-serving reasons not to provide it if it is unfavorable. The buyer will therefore need to have her concerns assuaged in order for the parties to agree on terms—that is, for the buyer to offer a non-lemons price, a price that values the seller as being of normal (or even high) quality, not low quality.<sup>16</sup> If the buyer is not sufficiently convinced, the deal will not occur. Thus, as noted above, it is in the seller's interest to solve the problem: the seller won't prevail by giving a rosy view of what he is selling that the buyer will not believe. Rather, he needs to arrange for the provision of credible information, or compensation for the buyer if what the seller is selling really is a lemon.

Again, the general solution for lemons problems involves incentive alignment. The information possessor may agree to suffer a sanction if she provides incorrect information, or an expert with a reputational stake may be used. The information is credible because of the information provider's incentives, to avoid the sanction, or to keep and improve its reputation, as the case may be. There may be a compensatory mechanism as well—either in an economy of scope with incentive alignment, such as when the seller gives a money-back guarantee, or, in some other manner there is provision for the buyer to be made whole if the information was not accurate.<sup>17</sup>

But what is important for purposes of this analysis is that there exists a “truth,” some mechanism by which a deal is done that yields convergence on valuation based on that truth, and an ultimate consensus as to that truth (or ultimate settling-up based on the agreed-upon valuation).

This formulation is also applicable to another problem relating to information that neither party possesses, and that will only be revealed

15. See Gilson, *supra* note 6, at 262–69. Of course, information about the future is always incomplete and not amenable to “discovery.” But there is often enough of a basis by which parties’ valuations can and do converge sufficiently to make a deal. In the cases at issue here, the valuations don’t converge sufficiently, but there is nevertheless a solution that enables them to make a deal, as discussed in the text in this Section and in Gilson, *supra* note 6.

16. As discussed in *infra* note 17, if the concerns could not be assuaged, high-quality items would not be sold, since the buyer could not be convinced to pay the correct price. Thus, “the bad would drive out the good.” But I (reasonably) assume that in the contexts I am concerned with, the concerns can be assuaged.

17. See HILL ET AL., *supra* note 9, at 369. In public deals, the information not being true should allow the other party to refuse to close—to walk away from the transaction. Indeed, it should be noted that “money-back guarantee” is phraseology from the used car and like examples; here, it is used as shorthand for representations and warranties and indemnification.

after third parties or nature act.<sup>18</sup> Of course, stated in this manner, the “problem” pervades all of deal-making: the basis of almost all valuation in the M&A transactional context is the present value of future cash flows, which necessarily turns on what will happen in the future. The process of deal-making involves converging on that valuation. Complicating attempts at convergence, even where there is no hidden information to elicit, the parties’ differing views are self-serving: the seller is presumably more optimistic than the buyer as to the business’s prospects. Both parties may sincerely hold their optimistic/pessimistic views about the future; there is no hidden information to elicit, thus making a solution focused on elicitation of information unavailing.

But in two stylized contexts, parties have addressed the problem that the parties can’t agree when contracting on what the future holds, by agreeing on principles to be applied depending on what happens in the future. The contexts are ones in which coming to such an agreement is (apparently) cheaper and easier than attempting a pre-closing convergence.

The agreements take the form of “contingent value rights (CVR),” common in private (and some public) life sciences acquisitions, and “earn outs” in private acquisitions. The former provide for additional consideration to selling shareholders if certain discrete events, such as regulatory approval of a product, occur, or if specified performance targets are met.<sup>19</sup> The latter are triggered by performance targets as well, and reflect in part that less sufficiently-vetted information is available about a private company, and that the private company may be changing significantly under its new ownership.<sup>20</sup> More specifically, the parties don’t agree on the amount of future profits, but they can agree on how much future profits would be worth. They don’t agree on the likelihood that some permit would be granted or that litigation would be resolved in a particular way, but they can agree on how much either such outcome would be worth. The contract provides for ex post settling up reflecting how the future has unfolded.

For present purposes, what is important is that the parties’ valuation gap can be sufficiently well eliminated by an assessment, albeit ex post, of the “truth.” The obstacle to agreeing on valuation was that the parties’ ex ante assessments were too far apart, with no plausible way to reach consensus; the obstacle was overcome when the parties agreed to make the

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18. See *supra* note 9 and accompanying text.

19. See generally Igor Kirman et al., *Contingent Value Rights (CVRs), PRACTICAL L.* (2019), <http://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.26465.19.pdf> [https://perma.cc/83M3-6V6Y].

20. See generally HILL ET AL., *supra* note 9, at 363–69; see also Gilson, *supra* note 6, at 263–69.



assessment when more was known. Again, the underlying assumption is that the information will exist, and that the parties will agree on what it is. (Seller's company (Target) achieved profits of X; therefore, the earnout yields Y dollars to the seller; Target obtained a patent on its invention; therefore, the CVRs given to Target's shareholders in the merger come to be worth Z).

Whether the parties are attempting to converge on their valuation of information one party has or that neither party has, for the "harder" types of information described thus far, the generic approach focuses on lowest-cost production of credible information, whatever that entails. Different parties will be differently situated as to accessing or producing information (and bearing associated costs, of information production or of warranting the truth of particular information), and sometimes, non-parties (often, experts) will be utilized. Consider the parties' negotiations regarding whether the target is subject to any litigation, or whether any litigation is pending or threatened. Clearly, the seller will be in a better position than the buyer to know whether the target is being sued, or whether it is likely to be sued. How much the litigation risk—the likelihood of suit and the costs to the target of any such suit—should affect valuation can be assessed by several parties, including the target, the seller, and their lawyers; the buyer can do some investigation as well. Through some combination of expertise and risk allocation, the parties can converge on valuation. Present information, both information that might be hidden (or simply missed) and information nobody has, can be sufficiently well obtained. Future assessments cannot be made with precision, but again, there is a path to convergence: the parties make an allocation among themselves based on the information they have been able to obtain, and one party, typically the buyer, bears any residual risk.<sup>21</sup>

## II. THE PROBLEM PART TWO

But much of what parties want to know is not nearly as satisfactorily addressed by this sort of approach. What sort of information is at issue? Information that does not have identifiable necessary and sufficient conditions; information that goes beyond specific things one could ask and become informed about; information that cannot simply be elicited from someone who may have an interest in concealing it or consulting an expert.

Of course, the distinction between harder and softer information is not binary; rather, it is on a continuum. The classic information asymmetry

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21. Especially in a private deal, the matter could be dealt with exceedingly cheaply if the seller agreed to bear all the risk (and its promise to do so was sufficiently credible and sufficiently well-funded, such as with an escrow of part of the sale proceeds). The buyer might conclude that the seller's confidence indicated that there was no risk, or that if the seller's confidence was misplaced, that the buyer would be fully compensated.

problems assume that concepts such as “good car” and “good worker” are well-defined, and that the agreement is a matter of consensus, to an extent greater than is the case. Still, many problems are far closer to one end than the other; again, much analysis about asymmetric information problems assumes that if the car seller or worker were Pinocchio or given truth serum, the problems would be solved. And when that is not possible, other techniques, again, can serve to counter the seller’s incentive to give false information with a counter incentive (for the seller or someone else, such as an expert) to give true information (for instance, having to bear costs, perhaps reputational, financial, or both for untruthful information). And in the situation where nature or a third party will act, the situation is of course more complicated as well: it’s not as though the computation of “profit” is completely mechanical, subject to precise agreement based upon a generally accepted formula. But still, in principle, the problem to be solved is tractable, and the solution uses what the parties agree will count as “the truth” for purposes of converging on valuation.

The problems this Essay is concerned with do not have this feature. Parties want to assess fit, culture, vision, and the like. And, particularly where the transaction involves one or more private companies, they are considering what they may not have thought to ask about—and, perhaps, the other party may not have thought to tell them.<sup>22</sup> Again, admittedly, this formulation overstates the distinction between the problems I am concerned with and those I characterize as satisfactorily solvable in principle. But the distinction is nevertheless a qualitative one. The problems I regard as solvable in principle, especially the lemons problems, are largely eliminated if there is a “truth” being asked for, and we can agree that it is, or is not, being told—that is, we can agree on an arbiter of truth, such as an expert or the passage of time.

### III. SOLUTIONS

The problems that are far less readily and directly solvable in principle are addressed in contracts, and in the contracting process—but how? Information, including and beyond what was directly requested, is ferreted out via *repetition*—repeated contact and repeated questioning.<sup>23</sup> *Rituals* arise as to how contracting proceeds; these rituals help create and define a community.<sup>24</sup> That community serves many functions: parties can signal their ability and willingness to abide by its norms, a signal that also serves as a bond that they have invested in the community and would suffer *reputational* and related costs if they violated the norms.<sup>25</sup> Hence

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22. See Hill, *Bargaining*, *supra* note 4, at 215.

23. See *id.*

24. See *id.*

25. See *id.* at 215, 219.

repetition, ritual, and reputation. Through these mechanisms, parties become sufficiently comfortable to proceed with the transaction on the terms they have agreed upon—they have acquired sufficient softer information. But they not have gotten to this point by knowing, and being able to ask about, precisely what they care about (that is, harder information), and getting answers they feel reasonable and justified relying on.

Third party experts may have an important role in providing parties to a transaction with information. One helpful way to contrast the difference between the acquisition of harder and softer information is to consider in more depth what expertise is, and is thought to consist of. To anticipate the punch line, the typical references to experts in the transactional setting concern the provision of harder information, but properly understood, expertise also implicates softer information, and the status of expert is often importantly based on a community assessment as much as, or even more than, some objective “fact of the matter.” Recall the comparison above between a technical expert, such as a mechanic or engineer, and another sort of expert, such as an expert in investing, assessing art, or clinical psychology.<sup>26</sup> The former can pass objective tests or do things that directly demonstrate their aptitudes. They could also have good reputations and credentials from recognized authorities, but these latter indicia are ultimately recursive—what is the authority of the reputation or credential-conferrers? The reputation probably would stem from good past results, which provides some, but scarcely dispositive, evidence. In many fields, such as investing, past results are notoriously bad predictors of future success.<sup>27</sup> In some fields, there may be real disagreement as to whether someone is an expert or not. What seems like “results” demonstrating expertise to one person may not be accepted as demonstrations of expertise by another. Is someone an expert in assessing art if she picks out pieces the market comes later to value, or prestigious museums then acquire? What if an art history professor thinks an artist is great but the artist has no market success?<sup>28</sup> What makes someone a successful clinical psychologist? Patient satisfaction? Appraisal of peers? A final example helps make the point. Contrast a well-respected investigative reporter with an investigative reporter who has a reputation as a conspiracy theorist.<sup>29</sup> Sometimes, what seemed like a conspiracy

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26. See *supra* note 12 for references on expertise.

27. A google search on February 27, 2020 for the phrase (not in quotes) past performance is not an indication of future performance, yields 3,210,000,000 hits. See also PHILIP TETLOCK & DAN GARDNER, *SUPERFORECASTERS: THE ART AND SCIENCE OF PREDICTION* 5–8 (2015).

28. See Claire A. Hill, Book Review, 6 *UCLA ENT. L. REV.* 137, 144–45 (1998) (reviewing TYLER COWEN, *IN PRAISE OF COMMERCIAL CULTURE* (1998)).

29. What makes a theory a conspiracy theory and what makes someone a conspiracy theorist are, not surprisingly, extensively studied in the literature. See, e.g.,

theory is later shown to be true. The problem, again, is that we don't know "the fact of the matter"—that's why we are asking and listening to experts. But since we can't appraise the truth of what they say by checking it against some set of correct answers, we need to rely on proxies such as "does this theory sound like something that would be true?" The process of unpacking one's intuitions as to what makes something seem likely to be true or not quickly reveals how contingent and attenuated the inferential links are.

This semi-digression about expertise has two purposes. First, as noted above, to contrast the role harder information problems assign experts with a broader assessment of when expertise might be called upon and the extent to which "expertise" is a contested designation. Second, this discussion of expertise is a microcosm and exemplar of the dynamic I am hypothesizing overall, particularly as to softer information. There are some "objective" indicia that there is expertise and that the expert to be consulted has it, but the use of expertise and a particular expert, and the weight to be accorded to particular expert assessments, is significantly informed by community norms.

How do contracts and the contracting process address the acquisition of softer information? Again, among the most important techniques are repetition, ritual, and reputation. Repetition, in the overlaps built into the due diligence process thanks to many standard representations and warranties. A seller makes representations about the target's big contracts, its long contracts, and its real estate contracts. It makes representations that it is not violating law, but also that it is not violating particular laws. While this is to some extent about catching lies—it is harder to lie many times than once—and about jogging memories, it is also about a process, a back-and forth in which there are revelations about tone, record-keeping, business culture, and other important matters.

Ritual and reputation are also an important part of the picture. By rituals I mean those involved in the contracting process—the drafts back and forth alongside the negotiations that start with "forms" from previous deals, adapting them to new situations in frenzied bursts of changes, changing only what parties realize needs to be changed each time, and leaving the final product, a very expensive "customized" one that purportedly articulates with precision and specificity the deal the parties want for a judge, nevertheless an inelegant, redundant, and not infrequently self-contradictory mess.<sup>30</sup> Indeed, this account, in which repetition, ritual, and reputation help with the acquisition of softer information, may explain some features of contracting as to which

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JOSEPH E. USCINSKI & JOSEPH M. PARENT, *AMERICAN CONSPIRACY THEORIES* (2014); *CONSPIRACY THEORIES: THE PHILOSOPHICAL DEBATE* (David Coady ed., 2006).

30. This account builds on arguments I made in Hill, *Legalese*, *supra* note 10 and Hill, *Bargaining*, *supra* note 4.

standard accounts fall short, such as why contract terms, and the whole process, are as sticky as they are.

I argued in other work that the process and product of contracting creates and maintains a reputational community.<sup>31</sup> Membership in the community is “signaled,” partly but not wholly in the Spence sense, by one’s ability and willingness to learn and participate in the rituals, much as a job seeker signals his minimal desirability as an employee by being on time to the interview, bringing his resume, and wearing a suit (or whatever the analogue is in the job at issue). The Spence component is in the willingness to learn and participate in the rituals—doing so is an investment which will not be worthwhile if the party does not continue to act in accordance with the community norms. The person bought a suit, reasoning that the investment would pay off because of improved job prospects. The non-Spence component is in the ability to figure out what the community norms require, and thereby demonstrate institutional competence. The person knows enough to know that people wear suits at job interviews—that suggests they may know how they are expected to behave on the job. (Certainly, not wearing a suit when wearing a suit is the norm is evidence that the person does not know how to behave on the job or that they are unwilling to do so.) Returning to the transactional sphere, parties would typically, for instance, ask for terms that are “market” or close enough. Considerable information is conveyed if a party does not follow the usual norms. A party unknowingly or self-righteously proposing terms that deviate significantly from “market”<sup>32</sup> has communicated something important about themselves as a transacting partner. The community can (and typically does) have a collective sense of what constitutes good faith and what does not.<sup>33</sup> Notably, the community is able to police particularly spirit-violative behavior, providing norms where what the parties want and expect from each other cannot be described or enforced more specifically. For instance, imagine that a contracting party “tells the truth” in a defensibly “plain meaning” sense, but is, perhaps, leaving something important out, a state of affairs that could be addressed through legal processes, but not very well.

This account is more radical than it might seem, and suggests some broader lessons. Consider a seemingly uncontroversial articulation of information acquisition: one acquires more information until the benefit

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31. Hill, *Bargaining*, *supra* note 4, at 217–18; *see also* Hill, *supra* note 13, at 29, 35.

32. Indeed, a search on Google or the Practical Law Company database for “what is market” yields many results. And Bloomberg and other technology companies are developing technology to enable deal participants to compare their deal documents with documents that are considered “market.”

33. I discuss this issue in Claire A. Hill, *Why Financial Appearances Might Matter: An Explanation for “Dirty Pooling” and Some Other Types of Financial Cosmetics*, 22 DEL. J. CORP. L. 141, 147–49 (1997).

of additional information exceeds the cost of acquiring it. The argument above suggests that information acquisition costs are particularly hard to quantify, even as a matter of theory. Insofar as one can't specify precisely what it is one wants to know in a manner that lends itself to honed investigation (as opposed to, say, "how much money have they committed to spend over x period of time"), parties make inquiries, using well-worn contracting rituals, until they have, in the familiar formulation, "gotten comfortable."

The ritualistic nature of deal negotiations is particularly well illustrated in an old but venerable book by James Freund, a long-time partner at Skadden Arps, *Anatomy of a Merger*.<sup>34</sup> The last chapter, from which I quote below, is a "play" about a negotiation for a deal between a purchaser and a seller, with principals and lawyers on each side helpfully having names starting with P or S.

#### **"FENCING FOR POSITION"**

**[Purr's handsome, spacious office at Proliferating, adorned with framed tombstone ads of past underwritings and acquisitions. It's Tuesday, December 17. Present are: PURR, Pat PISTOL (PPI's financial vice president), STRATOSPHERE, and Sid SERPENTINE (SSL's financial vice president). Representatives of each side have been summarizing their company's business, history, operations, and prospects in very general terms for about an hour.]**

PURR: The more I hear, Stan, the more I like the sound of this deal.

STRATOSPHERE: Me too, Paul.

PURR: Okay, Stan, let's get down to business. What's your asking price?

SERPENTINE: [Breaking in before Stratosphere can reply.] Paul, we weren't even *for sale* before today! There's no price tag on Suggestive. The real question is: what are you willing to offer?

*[This could go on for hours, with each party maneuvering to avoid throwing out the first price. So we'll skip ahead here a bit. . . .]*

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34. JAMES C. FREUND, *ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS*, 482–83, 489–91 (1975).

PURR: Look, let's cut through the niceties. How does \$1,000,000 in our stock sound to you, Stan?

SERPENTINE: Oh, come on, Paul. Your sidekick, Pat here, knows our after-tax earnings for the year will be in the neighborhood of \$300,000. And you've heard what that mini-conglomerate, Snatchemup Corp., paid our friends at On-Line Data based on a 12-times multiple. . . .

PISTOL: Sure, Sid, but that was nine months ago when the market was booming along. Nobody's paying 12-times today. . . . And besides, I'm not so sure you're going to make that \$300,000. . . .

STRATOSPHERE: Paul, I swear, if I had quoted you a price, it would have been three and a half million dollars.

PURR: Hey, that's stratospheric!

*[This goes on for several more hours, with the gap narrowing considerably although not completely resolved. At this point, rather than risk antagonizing Stratosphere irrevocably, Purr wisely calls a halt.]*

PURR: Listen, Stan, I think we're finally starting to play in the same ballpark. There are other matters besides price that have to be discussed. Why don't we call it a day and meet tomorrow with our lawyers.

STRATOSPHERE: That's a good idea. . . .

#### **"PUTTING IT IN BLACK AND WHITE"**

**[It is [some time] later, [] in Purr's office. Present are PRUDENT and Pete PREPPIE, a new associate in Prudent's firm.]**

PRUDENT: Well, Pete, I was right. I told you before the meeting we might need a letter of intent. Thanks for drafting one and bringing it over.

*[Good preparation on Prudent's part. Always have a draft letter of intent ready, with holes appropriate for filling—just in case you have to move fast.]*

PREPPIE: I hope it's all right, sir; I didn't have much to go on.

PRUDENT: It's fine, Pete. There are a few changes I think we should make, though. In the first place, I'm going to delete all this junk about the document not being a contract binding on the

parties, that anyone can tear it up at their pleasure, and so on. We can achieve the same legal effect by simply making the deal subject to execution of a definitive contract and PPI Board approval. I don't want to give those Suggestive fellows the feeling that it's all *that* non-binding; at the very least, I would like them to feel a strong moral obligation.<sup>35</sup>

#### IV. A ROLE FOR JUSTIFICATION

The foregoing describes a *modus operandi* for parties seeking to make deals. The overall paradigm is that the parties are seeking to come to agreement at the lowest cost, with each mindful that the other will only pay a non-lemons price if she can be sufficiently convinced that the party and the deal are not "lemons." Where what is at issue is just information that nobody has, the aim is to obtain that information as cheaply as possible. The transactional pie is thereby made larger. (And of course, the consequent risk allocations are part of this story; recall the litigation risk example discussed above.)

Where harder information is what's at issue, the truth-serum/use of experts/ex-post settling up solutions in theory yield determinate and satisfactory results. ("In theory" is of course crucial here. In the real world, the fact that the car/business is a lemon somehow might not be elicited notwithstanding techniques that should have worked, and certainly, arguments about earn-outs and other types of ex-post settling-up are notorious, with many commentators and lawyers discouraging them altogether simply for that reason.<sup>36</sup> Earn-outs present other sorts of issues as well;<sup>37</sup> this discussion simply refers to their workings in theory to deal with valuing the future.) The truth is elicited, or the parties agree on a formula that deals with what will happen when the truth is elicited. The parties, again in theory, "get it right" as to the matters at issue.

By contrast, with softer information, the parties' convergence on a valuation is far less anchored to some "truth"—rather, it is anchored to what, through the negotiation process, the parties have settled on as a common understanding, through, again, repetition, ritual, and reputation. The repetition may have yielded information of a "harder" type—a contract that was remembered after it was asked about in several different ways, a pesky ex-employee whose dissatisfaction barely registered but is

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35. *Id.* at 482–83, 489 (citations omitted).

36. *See, e.g., Advanced Earn-Out Issues*, WINSTON & STRAWN 44, 52, 58 (2014), <https://www.winston.com/images/content/7/6/v2/76231/Advanced-Earn-Out-Issues2.pdf> [<https://perma.cc/V4CE-FWPU>].

37. *See, e.g., Jim Schleckser, The Problems with Earn-Outs When Buying or Selling a Company*, INC., <https://www.inc.com/jim-schleckser/the-problems-with-earn-outs-when-buying-or-selling-a-company.html> [<https://perma.cc/6EZ9-48WP>]. *See generally* HILL ET AL., *supra* note 9, at 363–69.



now remembered, and so on. But it also yielded information about fit, comfort with how the business was run, how the principals dealt with their lawyers and their counterparts and the counterparts' lawyers, etc. Similarly, the extent to which the parties comported themselves in accordance with market norms yielded valuable information as well, information that helped the deal be agreed upon. But consider the chain of inferences from that information to valuation, and how it compares to the chain of inferences at issue in, for instance, the lemons scenario, in which "the mechanic vouches for the car."

Of course, in all transactions, parties are seeking both types of information, and valuation is importantly done for the whole enterprise. This leads to my final point.

Some transactions ultimately work well; some do not. Dealmakers—both lawyers and principals—will go on to make other deals, or at least, most often, stay in the relevant business community. They will be judged, particularly by other market participants, on whether their deals were successful. If a deal is not successful, participants will presumably have to justify to other participants and to markets generally why they did what they did—why they were willing to do the deal on the terms at issue, or agree to pay or be paid whatever the deal consideration was. How will they do so? The less the valuation is mechanically and technically justified, the more that community norms will be the obvious way to proceed. "Everyone was agreeing to those valuation multiples for internet companies." "We really thought the culture would be a fit—an internal analysis, complemented by one from [prestigious consulting company], told us so."

As Alessio Paces and I argued in *The Neglected Role of Justification Under Uncertainty in Corporate Governance and Finance*, and I argued in *Justification Norms Under Uncertainty: A Preliminary Inquiry*,<sup>38</sup> economic decision-making importantly involves an ex ante consideration of ex post justifications. We argued further that for some decisions, the difference between the best decision as a substantive matter and the most justifiable decision was small. In principle, that would be the case for decisions based on "harder" information. But for information based on "softer" information, the difference becomes far larger. I argued in *Justification Norms Under Uncertainty*<sup>39</sup> that people making these sorts of decisions (such as complex investment decisions) will need a community, with norms that, when adhered to, provide justification. I argued that such communities and norms would be stickier than one might otherwise expect. My motivating example was Standard and Poor's and Moody's, the rating agencies that failed so disastrously in predicting the Enron, Worldcom and other debacles in the early 2000s and yet were again

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38. See generally Hill & Paces, *supra* note 13; Hill, *supra* note 13.

39. See generally Hill, *supra* note 13.

listened to when they gave disastrously incorrect ratings in the years leading up to the 2008 financial crisis.

#### WHAT FOLLOWS?

I began this Essay by distinguishing between harder and softer information. I sought to demonstrate that the orthodoxy on information acquisition in the transactional context (and in business contexts more broadly) focused too much on harder information, and that the otherwise puzzling state of contracts and contracting can be understood in part as addressing problems of acquiring softer information. But there is a broader point to be made. Especially for matters that are “softer,” individual decision-makers may need to justify their decisions; their attempts, *ex ante*, to be best able to provide a satisfactory justification requires a (social) consensus on what such a justification would be. How much information parties will get, and how they will get it, has much more of a social component than orthodox analyses appreciate.

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